HFMA briefing
February 2021

The NHS external audit market

Current issues and possible solutions

Introduction

We are increasingly hearing from our members that they are finding it difficult to appoint an external auditor, with little or no interest being shown in invitations to tender for external audit services. Some members have reported that their auditor has resigned or has declined to extend the current audit contract.

For the 2019/20 audits there were three NHS organisations that were unable to appoint an external auditor following the required audit appointment process. Auditors were eventually appointed after input from the national bodies. For 2020/21 one NHS body has appointed a firm that is new to the market.

Other NHS bodies have reported only one audit firm submitting a bid for work and with much higher audit fees being charged than in previous years. We have been told '*the NHS external audit market is broken*' by both NHS organisations and auditors themselves.

There are many complex intertwined factors leading to the current issues in the NHS external audit market, with similar issues being reported in local government. For many auditors, the issues centre around low audit fees, combined with NHS organisations seemingly uninterested in their auditor's work indicating that public sector audit has become commoditised and is not valued as highly as it used to be. This, combined with increased auditor regulation and audit scope, means that the market is no longer as attractive as it once was.

This comes at a time when it is perhaps more important than ever that we have a robust and transparent audit process to provide assurance over how taxpayers' money is being spent to meet the health needs of the population – including the money spent on Covid-19.

Based on our survey of finance directors, 42% of respondents' audit contracts were due to end in 2020/21 with a further 27% due to end in 2021/22. Therefore, it is important that the difficulties that NHS bodies are having with appointing auditors are understood and action is taken to resolve them as soon as possible.

This briefing aims to raise awareness of the current issues, causes and possible solutions. The briefing considers:

- the background to the current audit arrangements in the NHS
- recent events impacting the wider audit market, up to and including the Redmond review
- current issues for NHS bodies and their auditors based on the outcome of a survey of finance directors and discussions with auditors and other interested parties. The issues include:
  - the tendering process
  - audit interest
  - risk
  - capacity
  - fees.

The briefing concludes with some suggested ways forward including actions NHS bodies can take in the short term. However, the main intention of the briefing is to raise awareness of the problem and feed into the discissions that NHS bodies, auditors and regulators are having locally and nationally.

Background

External audit procurement requirements

England

The Audit Commission used to be responsible for appointing auditors to local public sector bodies and setting audit fees. It produced the *Code of audit practice*, undertook quality reviews and carried out national studies. Until 2012, the Audit Commission used its own staff to carry out around 70% of the audits, with the remainder being carried out by audit firms. A limited number of the large audit firms met the Audit Commission's procurement requirements.

The *Health and Social Care (Community Health and Standards) Act 2003* established NHS foundation trusts and their regulatory body, Monitor[1]. From the date of their establishment, NHS foundation trusts procured and appointed their own auditors once their existing audit contract ended. Audit Commission auditors could be the appointed auditor of an NHS foundation trust, but the Audit Commission played no role in their appointment or quality reviews. It is interesting to note that there were no new entrants to the audit market for NHS foundation trusts. From 1 April 2004 until 31 March 2015, NHS foundation trusts' auditors followed the *Audit code for NHS foundation trusts* published by Monitor.

The Audit Commission formally closed in 2015. Public Sector Audit Appointments (PSAA) Limited was set up as the transitional body to manage the on-going audit contracts for 2015/16 and 2016/17. This included the audit contracts for all NHS trusts and clinical commissioning groups (CCGs). Since then, PSAA's role has been to appoint auditors to local government bodies, set the fees for those audits, manage the audit contracts, and oversee the delivery of the audit to the 98% of local government bodies that have opted-in to using PSAA. It no longer has a role in NHS audit arrangements.

As a result of *the Local Audit and Accountability Act 2014*[2] NHS trusts and CCGs were required to procure and locally appoint their own auditors from 2017/18. Appointments were made by December

[1] Legislation.gov.uk, *National Health Service Act 2006*
[2] Legislation.gov.uk, *Local Audit and Accountability Act 2014*

2016, in accordance with the guidance to assist with the process[3]. Since 1 April 2015, all NHS statutory audits have been carried out in line with the National Audit Office's *Code of audit practice*. Arrangements to monitor the quality of audits vary between NHS foundation trusts and NHS trusts and CCGs.

Wales and Scotland

In Wales, the local audits are performed by Audit Wales.

In Scotland, the Auditor General for Scotland appoints auditors to health boards. Audit Scotland undertakes 65% of these health board audits in house, while the audit firms undertake the other 35%.

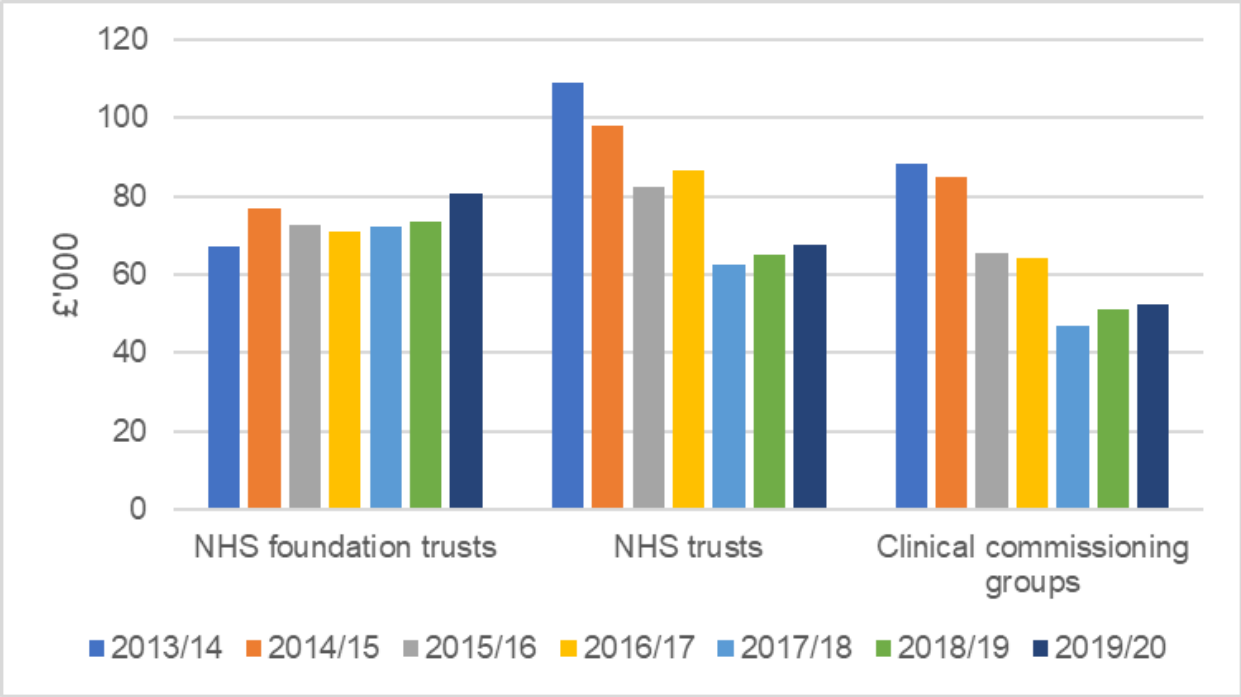
External audit fees

Figure 1 compares the average audit fee for the statutory audit by type of NHS body for the past six years. As a result of the changes outlined above, it is difficult to make meaningful comparisons of audit fees in the commissioning sector prior to 1 April 2013.

Audit fees for NHS trusts and CCGs show a decreasing trend since the end of the Audit Commission contracts until 2018/19 when there was an upturn. NHS foundation trusts' audit fees have remained more static but have shown a slight increase year on year since 2016/17.

These are average audit fees based on the total fees paid in each part of the NHS divided by the number of bodies in that sector. Looking at the data in more detail, more NHS bodies have seen their fees increase year on year than have seen static or declining fees (see below).

Figure 1: Average statutory audit fee by sector 2013/14 to 2019/20



Source: Annual reports and TACs

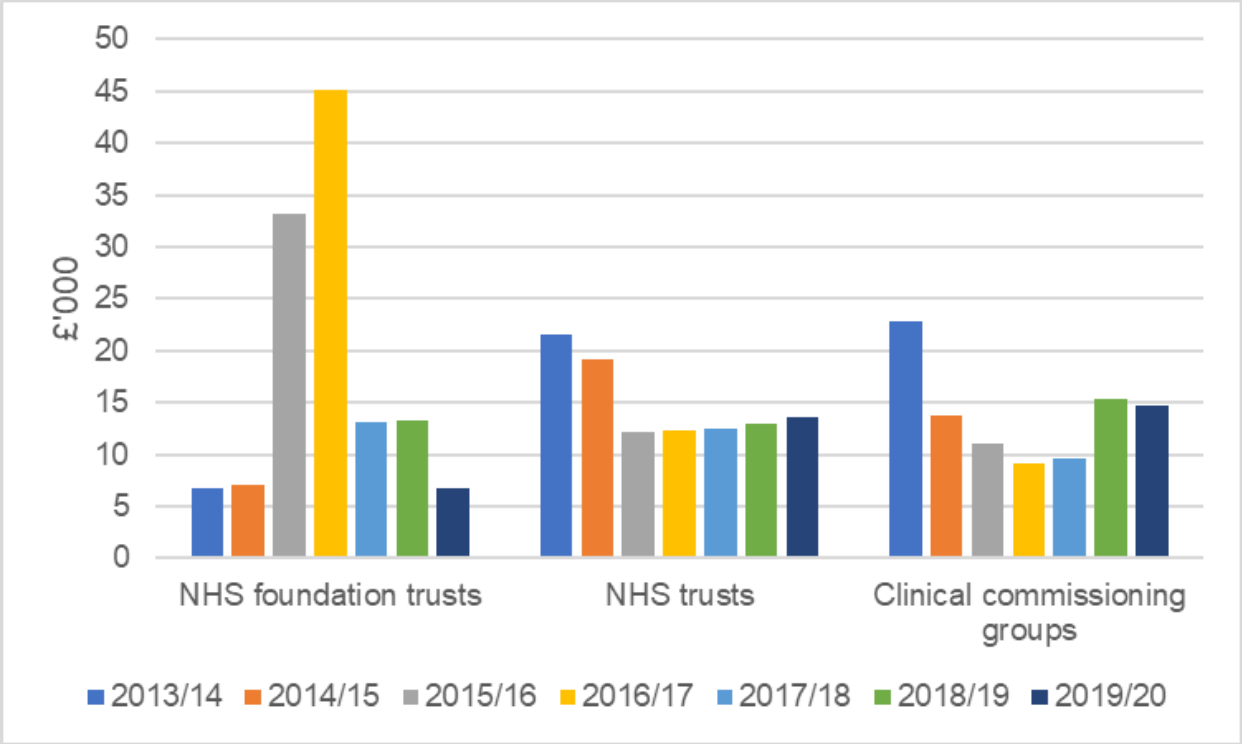
The other auditor remuneration by sector is more variable (see **figure 2**). The high level of other auditor remuneration for the NHS foundation trust sector in 2016/17 is due to additional work undertaken at a very small number of NHS foundation trusts – in one case the additional work was

[3] Department of Health, *Guidance on the local procurement of external auditors for NHS trusts and CCGs*, March 2016

tax advice, in the other cases it was not possible to identify the reason from the annual report and accounts. In 2015/16, the additional work was done at slightly more NHS foundation trusts, in three cases it related to tax compliance services and tax advice but mostly the additional fees fell into the 'other' category.

The amount of non-audit work that auditors can do is now limited. Auditors are prohibited from providing many services, including the provision of taxation advice and advisory work, such as services linked to financing, capital structure and investment strategy of the audited body. There is also a cap on the amount of allowed non-audit work that auditors can do – the total non-audit fees paid to the audit firm in a year should not exceed 70% of the total fee for all audit work for that year[4]. This makes external audit work less attractive, at the same time as fees and timescales are constrained and audit requirements are increasing.

Figure 2: Average other auditor remuneration by sector 2013/14 to 2019/20



Source: Annual reports and TACs

The impact on fees of changing audit firms

In 2017/18, 21 NHS trusts changed their auditor. For 14 (66%) of these bodies, their audit fee reduced from the previous year, for the other seven the fee increased. The highest fee increase was a 30% increase with the largest reduction being 27% from the previous year.

In 2018/19, only four NHS trusts changed their auditor – for 3 (75%) of those the audit fee reduced and there was no change for the fourth. In the same year, 18 NHS foundation trusts changed their auditor, for 11 (61%) the audit fee reduced, there was no change for one and for the rest (28%) the fee increased.

Overall, in 2018/19, 23 (29%) of all NHS trusts and 44 (29%) foundation trusts saw a reduction in audit fees. It should be noted that none of this analysis considers changes to the NHS body, for

[4] FRC, *Revised ethical standards 2019*, December 2019 and NAO, *Auditor guidance note 1 (AGN 01): general guidance supporting local audit*, May 2020

example, changes in service provision or financial position, or merger of NHS bodies or change in status that would impact on an auditor's risk assessment and therefore the audit fee.

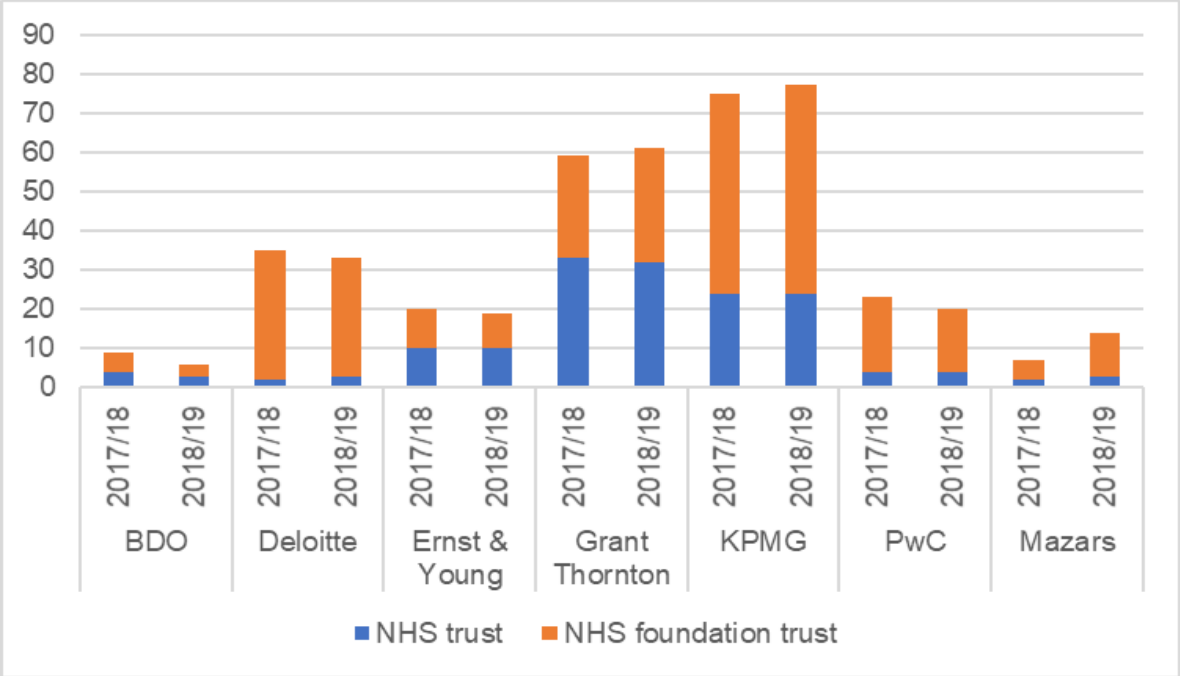
It is also worth noting that a number of the events that impacted the audit market, and therefore fees, happened in 2018/19 but would have happened after the tenders for these audits were submitted. Carillion went out of business in January 2018, the Kingman report was published in December 2018 and then Patisserie Valerie reported losses in early 2019.

Audit firms working in the NHS

Since 1 November 2015, under the *Local Audit and Accountability Act 2014,* to be appointed as the external auditor of an NHS trust or CCG, audit firms must be registered by a recognised supervisory body – in England, this is the Institute of Chartered Accountants for England and Wales (ICAEW)[5]. This means that firms need to meet eligibility criteria to enter the market. There are currently eight firms that are registered, but one of these does not currently undertake external audits in the NHS (see **figure 3**).

NHS foundation trusts can appoint a Companies Act auditor or auditors approved by NHS England and NHS Improvement[6] as well as those registered by the ICAEW[7]. NHS England and NHS Improvement's guidance requires that where a Companies Act auditor is appointed the NHS foundation trust has to ensure that the audit firm and the audit engagement lead are able to show a high level of experience and expertise. One of the ways that this can be demonstrated is for the auditor to have key audit partner (KAP) status.

Figure 3: Number of NHS trust and NHS foundation trust audit contracts



Source: Annual reports, NAO tool and PSAA

Until now, NHS foundation trusts have appointed auditors that are registered with the ICAEW under the *Local Audit and Accountability Act 2014* as KAPs so the number of firms in the NHS audit market

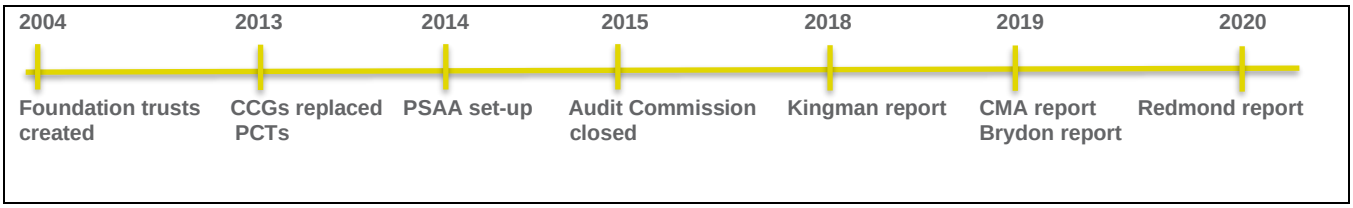
[5] ICAEW, *Local public audit in England*, accessed January 2021
[6] The statutory power lies with Monitor that now operates as part of NHS England and NHS Improvement
[7] NHS England and NHS Improvement, *Audit and assurance: a guide to governance for providers and commissioners*, December 2019

has not changed. However, in 2020/21 there is a new entrant to the audit market as Azurs have been appointed to audit an NHS foundation trust.

External audit reviews

In recent years there have been a number of high-profile cases of audit failures and a raft of reviews of the UK audit market (such as Kingman[8], Brydon[9], Competition and Markets Authority[10] and the Redmond review[11]). Although these reviews did not specifically look at NHS audits, they inform the context for audits and any resulting changes in audit regulation, auditing standards, audit firms or audit services will almost inevitably have an impact on all audits, including those of NHS bodies. **Figure 4** sets out the key structural changes and reviews undertaken within the last twenty years.

Figure 4: 2004 to 2020 – NHS key structural changes and reviews of the UK audit market



The Redmond review into the effectiveness of local audit and the transparency of local authority financial reporting referred to a number of key issues causing concern, including that 40% of local authority audits in 2018/19 were not completed by the statutory 31 July deadline. Since then, the PSAA has been reported that 55% of local authority 2019/20 audits were not completed by the revised deadline of 31 November 2020[12].

The Redmond review made 23 recommendations and included consideration of the potential impact of recommendations made as a result of the previous reviews noted above. Key recommendations on external audit regulation included that:

- a new body, the Office of Local Audit and Regulation (OLAR), should be created to manage, oversee and regulate local audit with the following key responsibilities:
  - procurement of local audit contracts
  - producing annual reports summarising the state of local audit
  - management of local audit contracts
  - monitoring and review of local audit performance
  - determining the code of local audit practice
  - and regulating the local audit sector.
- the governance arrangements within local authorities be reviewed by local councils with the purpose of:
  - an annual report being submitted to full council by the external auditor
  - consideration being given to the appointment of at least one independent member, suitably qualified, to the audit committee
  - formalising the facility for the chief executive, monitoring officer and chief financial officer to meet with the key audit partner at least annually
- the current fee structure for local audit be revised to ensure that adequate resources are deployed to meet the full extent of local audit requirements.

[8] DBEIS and FRC, *Financial Reporting Council: review 2018*, December 2018
[9] DBEIS, *The quality and effectiveness of audit independent review*, December 2019
[10] CMA, *Statutory audit market study*, April 2019
[11] Ministry of Housing, Communities and Local Government, *Local authority financial reporting and external audit: independent review*, September 2020
[12] PSAA, *News release: 2019/20 audited accounts*, 4 December 2020

- the deadline for publishing audited local authority accounts be revisited with a view to extending it to 30 September from 31 July each year.

The NHS external audit market is intertwined with the local government external audit market and the challenges are similar in both. Of the six firms with NHS audit appointments in 2019/10, four also were appointed auditors to local authorities that opted into the PSAA audit contracts. One of the two firms not engaged by the PSAA undertook one locally appointed local authority audit. Most NHS external audits are therefore completed by the same pool of staff as those completing local authority ones; and audits follow the same *Code of audit practice.* Any changes made in response to the Redmond review are likely to have implications for the NHS.

The Government responded to the recommendations made in the Redmond review in December 2020[13]. The responses to the key recommendations above are that:

- the government is not currently persuaded to establish a new body but will consider other options to deliver the finding of the Redmond review that a 'system leader' is required. This will include working with the Department of Health and Social Care (DHSC) to ensure that changes to the local authority audit arrangements do not create divergence from the NHS arrangements and can maximise opportunities for alignment and efficiency
- the government agrees with the recommendations in relation to governance arrangements and the Ministry of Housing, Communities and Local Government (MHCLG) will work with the Chartered Institute of Public Finance and Accountancy (CIPFA), the National Audit Office (NAO) and the Local Government Association (LGA) to put them into practice and to issue guidance
- there will be changes made to the regulations around setting and amending local authority fees that will enable changes to be made to audit fees during the financial year that they relate to. Also, the MHCLG has provided an additional £15m to local authorities and bodies covered by the *Code of audit practice*, such as fire and police authorities, in 2021/22 to support new burdens including the anticipated increase in audit fees
- the deadline for publishing audited local authority accounts will be 30 September for 2020/21 and 2021/22 – then the deadline will be reviewed (although the deadline is expected to be pushed back again in 2020/21 due to the ongoing pandemic). The MHCLG and DHSC will work together to set deadlines to try to mitigate the impact on auditors who undertake both local authority and NHS audits.

Current issues in the NHS audit market

External audit is an essential part of the process of accountability for public money, providing an independent review of the financial statements and value for money arrangements (VFM) in place. As well as providing assurance on the annual report and accounts, it provides confidence in non-financial information and helps to improve the systems and processes in place. The HFMA's recent survey of finance directors found that external auditors provide added value through benchmarking data, policy updates and commentary and conversations with audit committees. For some, this added value is expected to be enhanced by the new requirement to provide a commentary on their VFM arrangements[14].

Our survey found that 90% of finance directors rated the quality of the relationship with their external auditor as good or

In November and December 2020, the HFMA surveyed finance directors and chief finance officers about their experiences of external audit procurement. 60 responses were received from trusts (17%), foundation trusts (52%) and clinical commissioning groups (31%) finance directors and came from a range of geographical areas in England. All audit firms currently in the NHS external audit market were incumbent auditors to at least one of the NHS organisations that responded to the survey.

[13] MHCLG, *Local authority financial reporting and external audit: government response to the Redmond review*, December 2020
[14] HFMA, *Auditors' work on VFM arrangements under the new Code of Audit Practice*, October 2020

excellent. However, despite this, with increasing challenges faced by both finance directors and auditors, the current external audit system is not working well. Current issues are explored further below.

Lack of interest

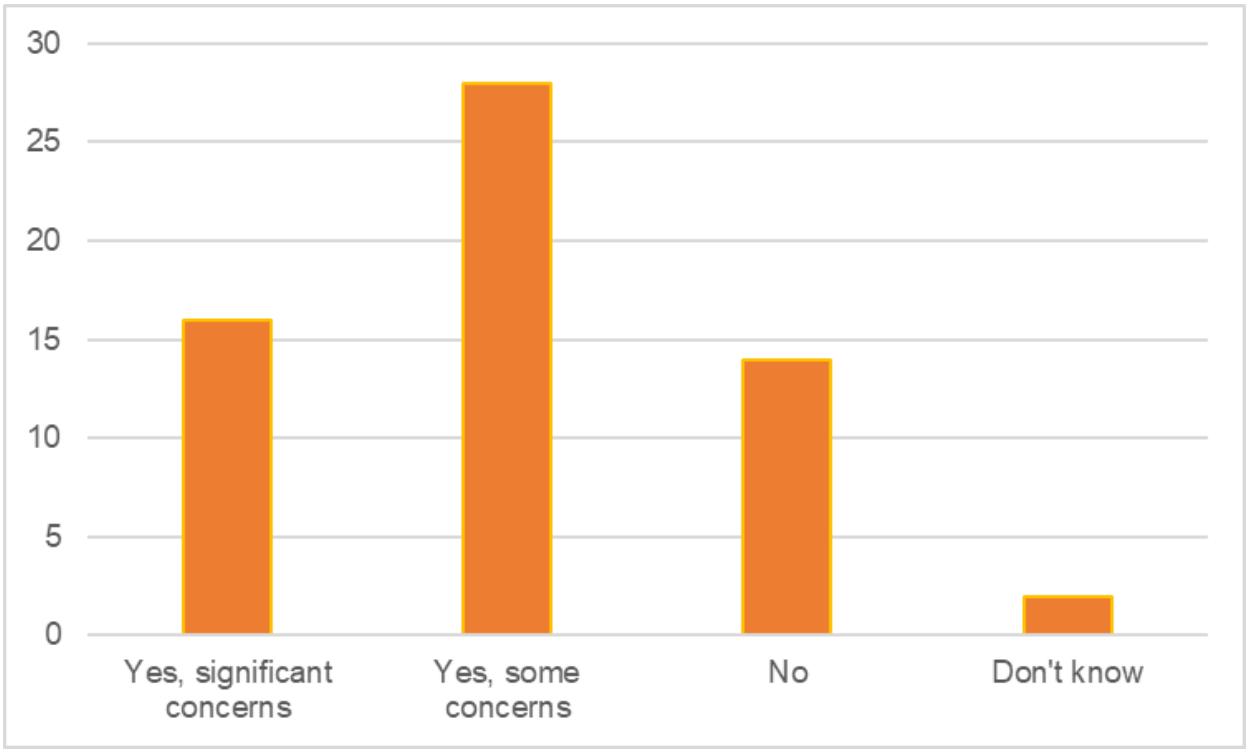
As set out above, individual contracts for external audit in the NHS have been in place since 2017/18 for NHS trusts and CCGs, and from their inception for NHS foundation trusts. A number of NHS bodies have additional audit contracts, such as for charitable funds and subsidiaries. A different auditor can be appointed for these, although it is most common for NHS bodies to award these contracts to the same auditors of their annual report and accounts.

Contracts can be let on different terms, usually for between two and five years with an option to extend for one or two years. In our survey, three quarters of the contracts were awarded for three years with an option to extend for one or two years. Some 42% of the contracts were due to end in 2020/21, with a further 27% due to end in 2021/22.

Of the survey respondents, 20 extended their contract in either 2019/20 or 2020/21. In some cases where extensions were not made this was due to incumbents resigning the contract or not being interested in bidding. 17 respondents re-tendered in either 2019/20 or 2020/21. The majority (59%) received only one response to their invitation to tender, one organisation received no responses at all, while 18% received three or more responses.

As shown in **figure 5**, 75% of respondents had concerns about their organisation's ability to appoint an auditor in the future. Finance directors cited examples of direct experience or knowledge of colleagues being unable to appoint an auditor. Concerns were raised over the lack of competition in the market impacting on choice, quality, and cost. This was particularly the case for smaller or more geographically remote organisations.

Figure 5: Survey findings – Do you have any concerns about your organisation's ability to appoint an auditor in the future?



Source: HFMA survey

Audit risk level

The level of audit risk impacts on the amount of audit work required and therefore both the fee and the attractiveness of the engagement. Over recent years, the increase in audit risk relates to both circumstances within NHS organisations and the audit regulatory requirements.

NHS financial statements

The NHS financial constraints and the financial incentives linked to meeting a set control total create a level of increased risk that the auditor must consider in accordance with international accounting standards. In accordance with ISA 200, 'the auditor shall maintain professional scepticism throughout the audit, recognising the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance.'[15]

This is not to say that auditors believe finance directors lack integrity, but it is important that they recognise the increasing pressure faced by them and the resulting impact on risk. The Comptroller and Auditor General's recent report[16] on the DHSC annual report and accounts 2019/20 may impact on auditors' assessment of this risk.

For many NHS bodies, there is also an increasing complexity factor which links to risk, such as NHS subsidiaries or new arrangements due to changes in ways of working. These will often require a specialist resource.

In some cases, auditors have reflected that the financial statements do not seem to have the same level of importance and attention attached to them as they historically did, particularly as timelines for completion have been brought forward. As one auditor commented, '*at my local government clients I meet the chief executives on a regular basis, but this is a struggle at my NHS clients where I even struggle to see the finance director as the financial statements are often overseen by the deputy director of finance.*'

Audit quality and regulation

Simply put by one auditor, '*the quality focus is relentless*'.

NHS bodies and auditors have a responsibility to clients, taxpayers and the public to focus on quality. There are clear professional standards to be met, with increasing emphasis on audit regulation. As one auditor commented, '*we expect finance staff, and auditors, to be more technical and be able to tell us what they are doing in accordance with which accounting standard and this has been a problem for many*.'

There is now significantly greater regulatory pressure on the audit firms to deliver higher quality audits and to demonstrate much greater professional scepticism. Different audits are subject to different types of regulation:

- the Financial Reporting Council (FRC) undertake audit quality reviews (AQRs) for major public audits – NHS trusts and CCGs that have total income or expenditure of at least £500m
- ICAEW undertake quality assurance department (QAD) visits for non-major trusts and CCGs
- NHS England and NHS Improvement appoint the QAD to undertake quality reviews for NHS foundation trusts.

Whilst the AQRs can often be seen as the most challenging inspections, both regulators are increasing their expectations leading to an increase in both the number of areas for auditors to focus on and the amount of work required in each area of focus. Expectations are only likely to increase further with the introduction of the Audit Reporting and Governance Authority (ARGA),

[15] IFAC, *International standard on auditing 240* (para 12), December 2009
[16] NAO, *The Department of Health and Social Care annual report and accounts 2019/20*, January 2021

due to shortly replace the FRC after calls for a stronger regulatory body, capable of enforcing higher audit standards set out in the Kingman review[17].

While an overall focus on high quality audit is welcomed, there are some areas for which it is felt that private sector assumptions provide the wrong emphasis for the public sector. There is a concern that auditors are working to a definition of a quality audit as one that satisfies the expectations of the inspectors rather than one that appropriately provides the assurance required by the users of public sector financial statements.

For example, the level of focus on property valuations. Public sector organisations carry their property at existing use value rather than cost or fair value. The level of accuracy of an existing use valuation of a property that is held for its service potential can never be the same as that of cost or a fair value of a property held to generate income – it is much more a matter of judgement with little market evidence to support the valuation. As the value of property is material to most NHS bodies, it attracts auditors' attention. Finance teams engage with valuers to ensure that the valuation is materially correct in the financial statements but pay little attention to issue other than at the year end. While NHS bodies recognise the requirement to comply with accounting and auditing standards, they struggle to understand the value to them of the audit work that may include remeasuring floor plans and engaging auditors' own valuation experts.

NHS bodies also report a similar issue for auditors' work on going concern – finance teams struggled to convince their auditors that the going concern basis is appropriate for their accounts even in the year that the government has announced that the NHS will get all the funding it needs to meet the demands of the Covid-19 pandemic. Instead, auditors were required to focus on the fact that the contracting arrangements were suspended due to the pandemic, meaning NHS bodies did not have signed contracts in place. It should be noted that it is expected that the changes made to Practice Note 10[18] will change the focus on going concern so this may not remain an issue going forward.

The FRC[19] and ICAEW[20 and 21] provide overall reports on quality monitoring. With the increased focus on quality, there is a clear increase in reputational risk for audit firms. They need to consider the risk of local audit to the firm overall, particularly if audit quality is being judged against standards that are difficult to meet in a public sector audit. The benefits of this are not obvious to most NHS organisations.

Another key area impacting on the NHS statutory audits is the move to a clear split between those completing internal audit and consultancy work from those completing external statutory audits. As set out in a letter from FRC in February 2020, 'We expect the firms to put in place independent governance for the audit practice and ensure that the audit practice is appropriately ring fenced from the rest of the firm so that financial results are clear and transparent'.[22]

Auditor capacity

The increase in risk leads to an increase in audit work required, impacting on existing auditor capacity to audit NHS financial statements. The shortage of supply of auditors able and willing to undertake this work is due to a range of factors including:

- **pool of public sector auditors:** Local public audit is a specialised job particularly at partner, director and manager level. There are specific differences between the audit of commercial organisations such as different accounting manuals, and additional reporting requirements in

17 Department for Business, Energy and Industrial Strategy, *Audit regime in the UK to be transformed with new regulator*, March 2019
18 Public Audit Forum, *Practice note 10: audit of financial statements and regularity of public sector bodies in the United Kingdom*, November 2020
19 FRC, *Major local audits – audit quality inspection*, October 2020
20 ICAEW, *Audit monitoring report 2020*, September 2020
21 NHS England and NHS Improvement, *Review of audits of NHS foundation trusts*, accessed 10 February 2021
22 FRC, *FRC writes to audit firms on operational separation*, February 2020

relation to VFM, regularity and quality accounts. Firms and individual KAPs need to be licensed as eligible to undertake local audits. The current list includes eight firms and 103 licensed KAPs[23]. The expertise sits with a small number of people, which is not currently expanding. There are movements from one firm to another, but not much evidence of new senior level recruitment from outside of the existing pool. It is not possible to tell how many KAPs have left the sector but only 10% of those currently on the list were licenced since 2016. Additionally, the structural change to meet regulatory requirements (as set out in the section above) means that audit firms need to balance the numbers of specialised public sector auditors that they employ against the risk that those staff are underutilised during some points of the year.

- **audit deadlines:** The window to complete the NHS financial statements is tight, particularly compared to the nine months after year end allowed for commercial audits. The NHS cannot be viewed in isolation from other sectors with the same staff often completing local authority, not for profit and education audits too. The change to the local government completion timescales to 31 July from 2017/18 accounts[24], has had a knock-on impact on the NHS audits with a significant short peak for the completion of public sector external audit work. In many cases this is managed by the use of contractors, but there is a limit to the availability and desire to use significant numbers of contractors as this brings with it issues of oversight, quality and training to manage. The tight deadlines also restrict opportunities for junior audit staff to gain experience and expertise to become specialist public sector auditors as they are only able to work on two audits over the year-end rather than the five that was previously the case.
- **conflicts of interest**: The value and lower scrutiny requirements of advisory and consultancy work and internal audit work makes bidding for external audit work less attractive. Firms that have designed or implemented internal control or risk management procedures in relation to financial systems or that have provided internal audit services are required to have a clean year between the provision of these services and the start of an external audit contract which prolongs the period of conflict.
- **geography**: The location of audited bodies has an impact on the supply of auditors. Audited bodies that are a distance from the auditor's home office will increase travelling time and expenses for the firm. However, the 2019/20 experience of remote auditing has demonstrated that this is perhaps less of a factor than it once was seen to be. NHS bodies may want to consider including their willingness to have at least some of their audit being undertaken remotely in their tender documentation.
- **volume:** The volume and length of contract will all be key factors in the supply of auditors. If contracts are shorter, providing less certainty of future work, the firm has less ability or incentive to invest in training of teams in the sector. NHS reorganisations impact on the number of contracts and their length.
- **attractiveness of work:** With the pressures identified above, public sector audit can be perceived as unattractive. An increasing number of staff move to commercial audit or leave to join financial services after they are qualified. Public sector audit can be more challenging with little benefit to an individual's career progression. As one auditor commented, '*auditors do not like to do things that don't make a difference – it is no good for morale or career progression and can be regarded as lesser work.*' It is important that auditors feel valued and respected and that public sector audit is seen as an attractive career choice.

As NHS organisations work more collaboratively, they are increasingly considering whether there are potential benefits from procuring audits together. This has been done successfully in at least one area, resulting in a better value for money audit fee for the NHS bodies and alignment of auditors in preparation for becoming an integrated care system (ICS).

[23] ICAEW, *Local audit register*, viewed December 2020

[24] This deadline was pushed back to 30 November in 2019/20 due to the Covid-19 pandemic. As a result of the Redmond review, it will move to 30 September for 2020/21 and 2021/22 although it is expected that the deadline for 2020/21 will be pushed back again as a result of the pandemic.

However, joint procurements can make it difficult for audit firms to tender for alongside their existing portfolios. This is because the NHS bodies are still separate statutory bodies that require separate audits so the firm may not have the capacity to undertake all of the new audits or they might have conflicts of interest at some of the bodies within a system. One possibility raised was a system procurement structured with different start dates for each organisation over a number of years. System wide procurement will limit opportunities for smaller audit firms to tender.

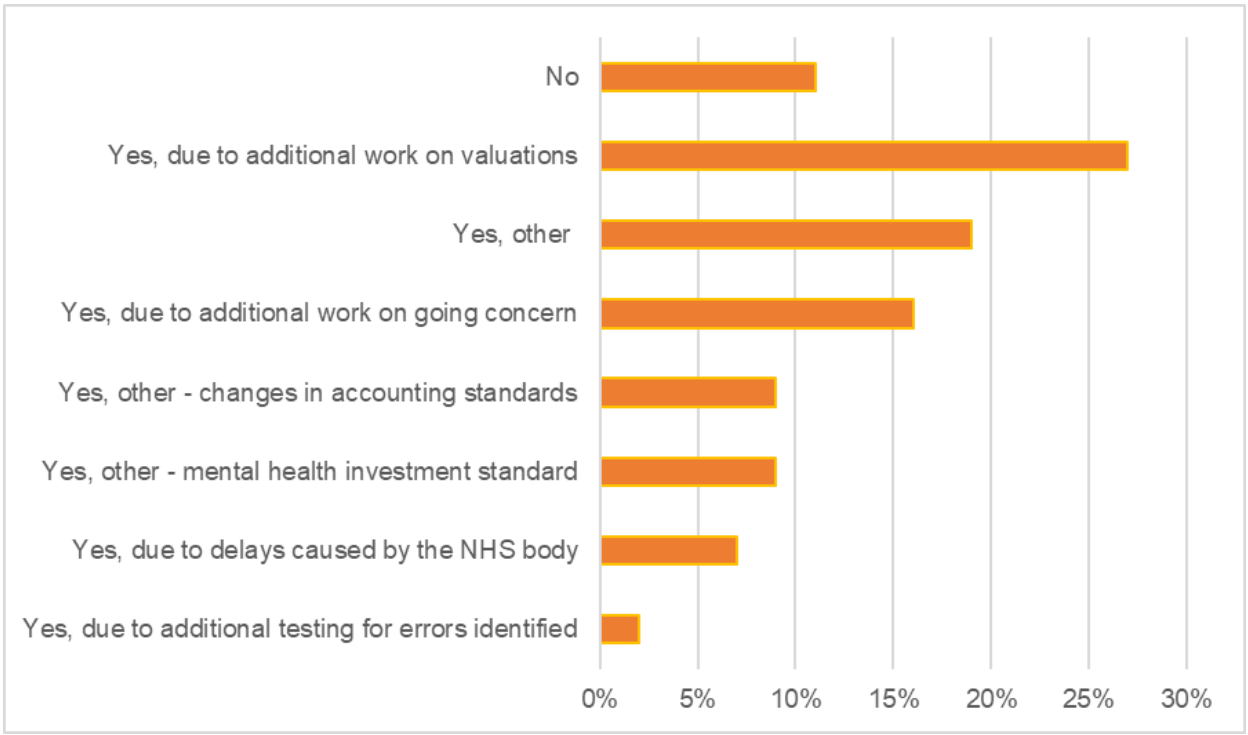
Legislation to make integrated care systems (ICSs) statutory bodies will change the audit market again.

Fee levels

As shown in **figure 1**, we are beginning to see a reversal of the downward trend in NHS external audit fees. The recent HFMA survey reflects this. Of the 60 respondents, 17 re-tendered in 2019/20 or 2020/21 with 13 of these resulting in an increased audit fee. For over half of these the increase was by over 20%, of which four were up by over 30%. Three of the remaining four either stayed the same or saw a decrease of less than 5%. For one, the decrease was greater due to the merger of five CCGs into one organisation. For the majority of respondents, the audit fees were between £50,000 and £75,000 (43%) and between £75,000 and £100,000 (33%).

The HFMA survey also asked whether the auditor had charged any additional amounts above the fee in the tender and engagement letter over the last two years. Of the 57 people who responded to this question, 81% had been charged additional fees.

Figure 6: Survey findings – In the last two years, has your auditor charged additional amounts above the fee in the tender and engagement letter?



Source: HFMA survey

Figure 6 shows 9% of additions were due solely to work required on the mental health investment standard. For others, the most common reason was additional work on valuations, followed by

additional work on going concern, IFRS changes, s30 referral letters[25] and the impact of Covid-19 on stocktakes. Some 9% cited delays caused by themselves or the need for additional testing due to errors identified. A number also noted the expected impact on 2020/21 fees in relation to the new VFM arrangements assessment.

Many survey respondents recognised the increased audit requirements as the reason for the increasing fee levels. Overall, 78% of respondents felt that the fee level was about right. However, 19% did feel that the fee level was too expensive, and one respondent wrote '*fees are increasingly like a blank cheque*'. Organisations can feel frustrated and helpless with regards to current audit fee levels. As explored by the ICAEW, in some cases the 'role is often misunderstood and different stakeholders have differing expectations of what an audit is and what the auditors should do, which often creates an audit expectations gap.'[26] As one respondent commented, '*while clear justifications have been offered for the recent fee increase it is hard to see the value to the trust*'.

From the auditors' perspective, there is also frustration. The current fee levels do not always allow them to complete the required level of work in a sustainable way. The size of the organisation makes little difference to the amount of audit work required to comply with auditing standards and the *Code of audit practice,* but it does drive the level of fee charged. Additional costs to develop infrastructure and respond to regulatory reviews add further pressure.

When faced with the choice between investing in public sector audit work or other areas, such as consultancy, the logical choice for audit firms is the latter as it is more profitable, less risky, and less pressured work. As one auditor commented, *'if you compare an NHS organisation to a large, listed company, you would get more time and money to audit the private sector company*' and as another commented, '*you would expect to be paid at least the rate of a plumber to be called out.*' For many auditors, the low audit fees, particularly in comparison to rates paid for consultants or valuers, is an indication that public sector audit has become commoditised with organisations uninterested in what is done or found – this can make them feel unvalued as a profession.

NHS audit fees cannot be seen in isolation. Increasing fees are a clear direction of travel for local authority audits too. If local authority prices do increase as part of future contract awards, this will have an impact on the NHS market, particularly if NHS bodies do not want to be priced out of a limited market.

Throughout our conversations, it has been clear that there are increasing pressures on finance directors to keep costs low and increasing challenges for auditors to complete their work within these fee levels. The consensus of opinion is that all are acting rationally as organisations, yet the current system is not working in the interests of any party.

Audit tendering process

There are three main procurement options for NHS external audit:

- through an Official Journal of the European Union (OJEU) procurement compliant with Public Contract Regulations (PCR 2015)
- below threshold trust procurement or
- from an existing framework agreement.[27]

In some cases, expressions of interest (direct or through a framework) are sought to determine the level of interest.

[25] Under section 30 of the *Audit and Accountability Act 2014*, auditors are required to make a referral to the Secretary of State for Health and Social Care when auditor believes that 'the body or an officer of the body is about to make, or has made, a decision which involves or would involve the body incurring unlawful expenditure, or is about to take or has begun to take a course of action which, if followed to its conclusion, would be unlawful and likely to cause a loss or deficiency.'

[26] ICAEW, *Local public audit: expectations gap*, October 2018

[27] Department of Health, *Guidance on the Local Procurement of External Auditors for NHS Trusts and CCGs*, March 2016

The tender process itself can impact on the level of interest in an audit. As NHS England and NHS Improvement recognise:

> 'there are procurement rules to adhere to, but the process also reflects on the organisation's credibility and its relationship with its external auditors. Some of the examples audit firms reported to us when NHS trusts and CCGs first appointed external auditors, suggested that audit chairs and senior finance team members were not always sufficiently involved in the procurement process to ensure a high-quality exercise'[28].

In 2018, ICAEW provided guidance to support local public bodies when they are in the process of tendering for external audit services[29]. Although interviewees commented that there is a mixed and improving picture, all identified examples of where improvements could still be made.

Issues identified in the tendering process include:

- **inclusion of non-relevant elements:** Auditors gave examples of tenders that include reference to internal audit related items such as a three-year strategy or days per audit; the requirement of a food hygiene certificate; and number of recommendations as a key performance indicator. This suggests that little time or finance input has been involved in agreeing the specification for tender. Dealing with these irrelevant details in the tender documents adds to the time the process takes on both sides and also may result in the auditor concluding that if this little care has been taken over the procurement process the same lack of care may be taken during the preparation of the annual report and accounts.
- **lack of differentiation:** Examples include tenders that have a heavy focus on cost or general questions such as 'do you have a business continuity plan?'. Tenders need to include questions which allow the organisation to assess what is most important to them in relation to an audit and what the distinguishing factor between firms will be, for example, expertise in analytics, mergers, ability to work remotely and so on.
- **weighting of different elements of bids:** Linked to the factors used to differentiate bids, tender assessment needs to include factors other than cost as part of the assessment. These may include quality as evidenced by external review, expertise and experience, level of specialist input to the audit, planned engagement levels by senior members of the audit team, training in public sector audits for junior audit team members and remote auditing capability. As one auditor put it '*The issue is that too often NHS audit tenders are procurement driven which sees cost as the main factor (often we see tenders based on 50% price and we tend to ignore those that have a weighting in excess of 30%)'*
- **inappropriate terms and conditions:** Examples include terms and conditions that cannot be applied to a statutory audit that has to be undertaken in accordance with auditing standards and the *Code of audit practice* or for a data processor when external auditors are data controllers. Although, in isolation, these issues are minor, they do take time for auditors to check and respond to.
- **lack of time between tender and audit start:** Examples of short lead in times, such as three months, were cited which does not allow enough time for staff planning and handover arrangements. One NHS body, at least, has concluded that the delay in putting their audit contract out to tender resulted in the incumbent firm deciding not to bid. It also suggests a lack of interest in audit and its importance, making the tender much less attractive to bid for.
- **tight timescales to complete tender:** Examples included 10 days from time of issue to submission, also during peak local authority audit times. This does not allow sufficient time to pull together a quality response which requires looking at conflicts of interest and identifying clarification questions. In the private sector it is usual for prospective auditors to meet with the audited body to understand the systems and risks. This used to happen in the NHS but has become rare now. It allows the auditor to understand the prospective audit much better and

[28] NHS England and NHS Improvement, *Audit and assurance: a guide to governance for providers and commissioners*, December 2019
[29] ICAEW, *Procurement – tendering for local public audit*, 2018

reduces the likelihood of changes to fees after the appointment when auditors subsequently identify issues that they would have factored into their bid.

What can NHS bodies do?

While recognising fundamental change is required to the NHS external audit market to ensure that it is sustainable for the future, those surveyed and interviewed agreed that there are some specific actions that can be undertaken now to make the audit appointment process as smooth as possible within the current framework. For NHS bodies, these include:

- understanding the competing pressures faced by all parties involved. A common comment in our research was that '*communication is critical*'. For example, it can feel like the level of work, and fee, is increasing without clear reasons being given or the benefits being understood. Sometimes it is not known why an incumbent auditor is not applying for a tender.
- establishing clear arrangements to ensure effective working relationships throughout the audit, including agreed working papers and communications. HFMA's briefing, *The external audit – best practice in working well together*, shares examples to help the audit of the financial statements go as smoothly as possible.[30]
- ensuring senior finance executives and audit committee members are involved in the tender specification to ensure it is high quality and focuses on what is of most relevance to the organisation.
- ensuring that tenders are issued in a timely manner (ideally more than a year before the start of the audit year and with at least a four-week timeframe to respond) and not during peak audit times, including local authority deadlines. It is helpful to consider pre-tender supplier days to feed into the specification to determine what might suit the local market such as length and size of contract.
- valuing the work of the auditor. There is a clear role for non-executive directors to understand the value of audit and the assurance that auditors provide. This may include discussing and following up on auditors' recommendations. The Redmond review included a recommendation for auditors to attend an annual meeting of the board – this is something that NHS organisations could implement where it is not already happening.
- considering accounting and audit implications as part of the risk assessment when establishing new or complex arrangements. This does not mean that the changes should not happen, but that the cost implications for specialist to review any complicated accounting and the potential impact on the audit fee are factored in.

What needs a nationally coordinated response?

As set out above, the Government response to the recommendations made in the Redmond report is likely to have a significant impact on the NHS external audit market. It is important that the response should be coordinated by all national bodies representing local government, NHS bodies and their auditors. Changes to the future arrangements will need to consider the impact of that response as well as the following areas:

- **timetable:** The NHS audit deadlines need to be assessed in the context of other public sector deadlines such as local authorities, charities, education and community interest companies. If these were mapped out to minimise the need for multiple teams it would help with capacity planning. For those firms working in both the NHS and local government, moving the NHS audits deadline to the end of June would help, but only if the local authority deadline was also moved to the end of September. Although this would ease capacity issues for the firms, it is not likely to be popular with NHS organisations. As one respondent commented, *'even though extending deadlines for completion of audits may help make the audits more attractive, this would not necessarily be the best solution. NHS organisations have other multiple tight deadlines throughout the year and extending the audit period could*

[30] HFMA, *The external audit – best practice in working well together*, February 2020

put further pressure on the organisation as more time and resource would subsequently have to go into overseeing and supporting the audit.'

- **support new entrants to the market:** There should be a focus on getting more of the accounting firms involved in NHS audits rather than focusing on those already in the market. This is likely to require initial support and time to build the infrastructure around training, technology and technical support. As there has only been one new entrant to the market in 2020/21, this should allow the cost of entering the market and level of support, from national bodies and the audited body, to be assessed.
- **independent oversight of fees:** Recognising the different issues faced for public sector audit, one option would be to have an independent body to manage the external audit market by appointing auditors and setting fees. In the light of the government's response to the Redmond recommendation this might be difficult to achieve, but may be popular with audited bodies, after all almost all local authorities opted into independent procurement when it was offered to them. It is important to recognise that this will only help if the underlying issues are addressed, rather than shifted from a local level to a national one. A more radical approach would be to move to the model applied in Scotland, where the Auditor General signs off the audit but sub-contracts some of the work to audit firms. This means that there is active control of audit quality and consistent application of technical views.
- **training:** Recognising the need for a clear 'public sector audit' career path with a strong emphasis on recruitment and training is needed in this area.
- **agreement on quality standards**: Clear agreement between auditors, audited bodies and their respective regulators of what would constitute a quality public sector audit. This could be started, if not concluded, by a summit of interested parties.

Conclusion

The whole local external audit market is fragile. The increases in audit risk, work and pressure have culminated in an NHS external audit market with increasing fees and an escalating lack of interest from the audit firms. If nothing changes, the situation is likely to get worse and we will quickly see more organisations unable to appoint auditors.

There are some relatively small actions that can be taken to help, but the issues will not be resolved without concerted, co-ordinated effort at a national and local level. This briefing is intended to raise the profile of the problem and identify some areas where action can be taken quickly. However, most of the issues will not be easy to resolve and will take some time – neither can they be addressed in isolation, any proposals for change need to be in the context of wider sector public reform.

It is likely to take a combination of significant changes including an increase in audit fees, changes to deadlines, perhaps a more significant role for an existing regulatory body or the establishment of another independent central body, co-ordinated work by the MHCLG, DHSC and other local government and NHS regulators, an improved understanding of the value of audit and independent scrutiny and, most importantly, a reinvigoration of the personal benefits of being a public sector auditor.

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- HFMA Policy and Research Committee

About the HFMA

The Healthcare Financial Management Association (HFMA) is the professional body for finance staff in healthcare. For nearly 70 years, it has provided independent and objective advice to its members and the wider healthcare community. It is a charitable organisation that promotes best practice and innovation in financial management and governance across the UK health economy through its local and national networks.

The association also analyses and responds to national policy and aims to exert influence in shaping the wider healthcare agenda. It has particular interest in promoting the highest professional standards in financial management and governance and is keen to work with other organisations to promote approaches that really are 'fit for purpose' and effective.

The HFMA offers a range of qualifications in healthcare business and finance at undergraduate and postgraduate level and can provide a route to an MBA in healthcare finance. The qualifications are delivered through HFMA's Academy which was launched in 2017 and has already established strong learner and alumni networks.

HFMA

1 Temple Way, Bristol BS2 0BU

T 0117 929 4789

E info@hfma.org.uk

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www.hfma.org.uk